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C O N F I D E N T I A L SECTION 01 OF 05 TEL AVIV 002067

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TAGS: ECON EFIN IS ECONOMY AND FINANCE ISRAEL RELATIONS
SUBJECT: NETANYAHU ANNOUNCES MAJOR TAX REDUCTION PROGRAM AND HIS DG ASKS FOR CORRESPONDING CHANGES TO LOAN GUARANTEE AGREEMENT 2004 TERMS SHEET

Summary:

¶1. (U) On Sunday, April 4th, Finance Minister Benjamin Netanyahu held a press conference at which he announced the third major tax reduction initiative of his tenure. It foresees the following changes in tax and investment laws:
-- personal income taxes, primarily for low-income workers, would fall significantly by July 2004;
-- corporate income taxes would fall from 36% to 30% by 2007;
-- taxes on construction materials such as steel, iron and bathroom fixtures would fall, a move aimed to stimulate this lagging sector of the economy;
-- industrial investments would be encouraged through tax code changes.

¶2. (C) Netanyahu estimated the cost of these changes at NIS 1.2 billion in 2004 and NIS 2.3 billion in 2005, which he said would be more than offset by tax revenue surpluses in both years. Netanyahu's political opponents say the move is purely political in nature and sets the stage for a potential race for the Prime Minister's job, should PM Sharon falter in his Gaza disengagement plan moves. Most aspects of Netanyahu's initiative require government and Knesset approval: at the earliest the income tax and corporate tax cuts would not go into effect before the second half of 2004. Although most press reaction to the plan has been positive, our contacts at the Bank of Israel expressed concern that Netanyahu is taking a risk in spending revenues that have not yet been booked.

¶3. (C) The plan also appears to run counter to understandings reached at the 2004 Joint Economic Development Group meeting, in which Netanyahu promised U.S. officials (including Under Secretary Larson and Treasury Under Secretary Taylor) to use extra revenues both to reduce taxes

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and also to reduce Israel's significant debt levels, which have reached 105% of GDP. This supposition is supported by new changes requested by the MoF to the Loan Guarantee Agreement (LGA) 2004 Terms Sheet, outlined in paragraph 13. End Summary.

The Plan

¶4. (U) Netanyahu's tax reduction plan is the third since he became Finance Minister a year ago. The first was contained in his economic reform plan of March 2003, and accelerated the provisions of the Rabinovitch Tax Reform Plan that cut upper bracket marginal income tax rates. The second, which was announced February 11, 2004, reduced VAT by 1% from 18% to 17%, reduced purchase taxes on consumer durables, and eliminated customs on certain food items.

¶5. (U) The April 4 plan, according to Netanyahu, is primarily intended to put more money in the pockets of wage earners in the NIS 4,000 to NIS 10,000 gross salary level, as well as bring down corporate taxes over a four year period. The main aspects of the plan are:

- Reduction in income tax. Wage earners earning NIS 4,000 a month will receive an additional NIS 59 a month, or NIS 708 per year. Those earning NIS 7,000 would receive an additional NIS 180 a month, resulting in NIS 2,160 a year, and those earning NIS 10,000 would receive an additional NIS 70, equal to an additional NIS 840 a year. This part of the plan requires Cabinet and Knesset approval. Netanyahu nonetheless said he hoped implementation could go into effect by July, 2004.

- Gradual reduction in corporate income tax from 36% today to 30% in 2007. Netanyahu said he was aiming to bring corporate tax rates more into line with OECD countries. Taxes would decline by 1% in 2004 to 35%, another 1% in 2005 to 34%, and 2% each year in 2006, and 2007, reaching 30% in 2007. This also requires Government and Knesset approval.

- Cancellation of purchase taxes on construction-related raw materials, including steel, iron, and equipment for bathrooms

and kitchens. This move is meant to stimulate the building and construction sector. Netanyahu announced that this step would go into effect immediately.

- Reforms in Investment Encouragement Law. These measures would aim to make industrial investments more attractive, and would include tax benefits totaling NIS one billion for investments in periphery areas. The new law would require new legislation.

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How He Did It: Excess Revenues Continue Pouring In
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¶6. (SBU) How could Netanyahu afford to take this expensive step? The Minister estimated at his press conference that GOI tax revenues are likely to be NIS 2 billion higher than originally forecast for 2004. This follows an April 2 MOF report on first quarter 2004 tax revenues showing that March receipts totaled NIS 13.7 billion, a real increase of 11% from March 2003. Tax revenues for the first quarter of 2004 totaled NIS 38.6 billion, a real increase of about 12% over the NIS 35.2 billion in revenues in the first quarter of ¶2003. This windfall, Netanyahu said, would more than cover the costs of the plan, which he estimated at NIS 1.2 billion in 2004, and approximately NIS 2.3 billion in 2005. He broke down the 2004 costs as follows:
-- income tax cut: NIS 650 million;
-- decline in company tax: NIS 400 million;
-- construction encouragement: NIS 150 million.

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Netanyahu's Economic Worldview versus David Klein's
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¶7. (SBU) Netanyahu's philosophy of using additional tax revenue to finance tax reductions is not universally accepted in Israel. Although BOI Governor Klein agrees with Netanyahu that additional tax revenues should not be used to increase government expenditures, he has repeatedly noted that this money should be used to reduce Israel's high level of public debt, which totaled 105 percent of GDP in 2003. This is significantly higher than the 78 percent average of OECD countries and 73 percent of EU countries. The BOI expressed this sentiment most clearly in a March 4 press release, noting that the debt/GDP ratio is one of the key indicators of an economy's stability in the eyes of foreign investors. Klein followed this on March 30 in his cover letter to the BOI's 2003 annual report, in which he wrote that additional tax revenues should be used to repay debt rather than further reducing taxes, as Israel's tax burden is approximately 39%, similar to OECD levels. In Klein's view, reducing the debt burden would result in lower interest payments, enabling lower interest, which would encourage investment, and support growth. In addition, Klein said that reduced debt servicing would allow for more money to be used for social-economic purposes.

Reaction: Politics, or Good Economics?

¶8. (SBU) The political opposition was quick to criticize Netanyahu's proposal. Avraham "Beiga" Shochat, former Labor-party Finance Minister, said in a radio interview April 4 that, although tax cuts are a good thing, the tax windfall should have been used to pay salaries to local authority workers who have not received salaries in months, as well as using it for education, health, and welfare. This was a reflection of the plan's political nature. Shochat's views were echoed by a number of other commentators.

¶9. (SBU) Yosi Bachar, Director General of the Finance Ministry argued in an April 5 radio interview that the measure is intended to help lower wage earners. He said that it is MOF policy to return extra tax revenues to Israeli citizens. He said the GOI's policy is consistent and clear) to encourage people to go to work, so that they will have more assets in their hands, not to increase public expenditures.

Bank of Israel Reaction to Plan: It's a Risk
MOF Responds: No It's Not

¶10. (C) The BOI's Research Division Chief, Karnit Flug, spoke to us April 4 about the new plan. On the one hand, she said that it followed "a legitimate path," particularly in view of the tendency of "political systems to spend revenue surpluses." She nonetheless highlighted three dangers: the GOI would be spending revenues that have not yet been booked; the plan precludes needed reductions in GOI debt levels; it does not help the very poor, who work but do not pay taxes. Although Flug thought the GOI could still meet its 2004 deficit target of 4% under the new plan, she believed that

meeting the 2005 deficit target of 3% was a "big problem."

¶11. (C) In a subsequent conversation with MoF DG Bachar, who called Deputy ECON Counselor to discuss changes to the Loan Guarantee Agreement 2004 Terms Sheet (see para. 13) related to the new plan, Bachar argued that the plan was necessary and timely. "Our highest priority is to make certain that politicians will not spend without control." He noted that the USG and the GOI were "coming from the same place" in efforts to reduce taxes. He also stressed that the additional growth resulting from the new tax regime would lead to significant additional growth that would do more to reduce debt reduction than any other GOI step. (Note: presumably including direct debt reduction). As for 2005, Bachar said that the GOI remains committed to attaining its deficit target that year, although he admitted doing so would require "major expenditure cuts."

Comment

¶12. (C) Neither Netanyahu nor his MoF staff provided the Embassy advance notice of his tax reduction plan, which appears to run counter to promises the MoF made to Under Secretaries Larson and Taylor at the recently concluded 2004

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Joint Economic Development Group meetings in Jerusalem. At the meetings, both the Minister and his DG agreed to use additional revenues to achieve two goals, tax reduction and debt reduction. Netanyahu's plan appears to run counter to that understanding. In an April 4 conversation with Embassy economic staff, MoF DG Bachar said the MoF desired to make more significant changes to the draft 2004 LGA terms sheet to take account of the new Netanyahu plan. He requested that Washington approve these changes as soon as possible, as the GOI wishes to go to market April 19. Embassy Economic Section staff, which has sent the text of the requested changes to Washington for review, noted the extent of the changes, and the fact that the language in question had been directly negotiated with the Under Secretaries during the recent JEDG. Bachar said he understood and looked forward to Washington's reaction to the changes. He noted that he could be contacted until the evening of April 6, at which point he would go on leave until April 20. Bachar noted he was designating Budget Director Yuri Yogev to act in his stead with regard to the Terms Sheet during Bachar's absence.

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Bachar's Requested Loan Guarantee Agreement Changes
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¶13. (C) On April 4, DG Bachar sent Deputy Economic Counselor his edits to the LGA 2004 Terms Sheet. We have forwarded these edits by e-mail to both State/IPA and to Treasury. (Note: These are in addition to one change made earlier in the month by Minister Netanyahu to the third tic in the first section of Appendix 4 referring to reducing the GOI's wage bill). The GOI's proposed Terms Sheet, including Bachar's changes, is included below. Bachar made three changes to the Terms Sheet; they are
¶1. Appendix 4, Section 2, Third Tic: Delete second sentence, "Due emphasis should be given to deficit reduction."
¶2. Appendix 5, Section 1, Table 1, Defense Consumption: Replace NIS 48.1 billion with 48 billion.
¶3. Appendix 5, Section 2, Second Tic, Number 2: Replace phrase "forecasted expenditure growth and to actual expenditure outturn" with "original budget plan to the previous year."

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Text of Appendices 4 and 5, as Amended by MoF DG Bachar
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(SBU) Begin Text of Appendix 4

Modifications to and Determinations of Specific Reforms Details in Annex II of the Loan Guarantee Commitment Agreement

The Joint Economic Development Group (JEDG), as the joint consultative mechanism referred to in Section 5.03 of the Loan Guarantee Commitment Agreement, and proceeding under Section 4.02 of the Loan Guarantee Commitment Agreement, determines and modifies the specific reforms referred to in Section 4.02 by appending the following as Appendices 4 and 5 of Annex II.

CONDITIONS FOR DISBURSEMENT OF THE SECOND TRANCHE OF SUPPLEMENTAL ASSISTANCE

The second tranche of bond guarantees in the amount of up to $3.0 billion will be released on determination of completion of the following:

¶1. Progress on Reform Plan: Progress on the main measures of the GOI economic reform plan. This plan includes, among other things, reforms related to:

-- Acceleration of tax reform: Continued progress on final implementation of tax reforms (legislated in the Knesset in 2002) by January, 2006;
-- Pension Reform: Continued long-term reduction in issuance of special government bonds for pension funds;
-- Continued reduction of public sector,s budgetary expense on the wage bill as a percentage of GDP, to be achieved mainly by reducing public sector employees.

¶2. Meet Spending and Budget Deficit Targets.
-- Commit to expenditures (defined in Appendix 5) in 2004 of no more than 226.1 billion New Israeli Shekels, with the firm goal of keeping the budget deficit to 4.0 percent of GDP or less.

-- Public dissemination and GOI commitment to a detailed, multi-year fiscal plan, including a commitment to limit real expenditure growth (defined in Appendix 5) to 1 percent per year from 2005 to 2010. Furthermore, commitment to maintain budget deficits to a level of less than 3 percent of GDP and aim to implement further reductions in the operational deficit of at least 0.5 percent of GDP every year until the deficit reaches 1 percent of GDP.

-- Any revenues in excess of those foreseen in the 2004 budget would be allocated to deficit and tax reduction.

¶3. Proceed with Privatization Plan
-- Further progress on the main measures of the Israeli government,s privatization plan. Future privatization steps should focus on the twin goals of increasing competition as well as reducing government involvement in the economy.

¶4. Implement Structural Reforms:
-- Increase competition in the economy by:
-- Implementing liberalization of the domestic telecommunications market through a regulatory environment that facilitates the introduction of competitive local landline services within the timeframe of this agreement;
-- Working to increase competition within the ports, financial markets, and electricity sectors;
-- Reduce governmental regulation with the aim of promoting economic growth.
-- Continue efforts to further strengthen IPR protection in Israel.

¶5. Undertake Infrastructure Investments
-- Commitment to, and progress on $1 billion in infrastructure spending as discussed in the GOI,s economic reform plan.

¶6. Other
-- The amount of guarantees that may be issued shall be reduced by an amount equal to the amount extended or estimated to have been extended by the GOI during the period from the last deduction to the date of issue of the 2004 guarantee, for activities which the President determines are inconsistent with the objectives and understandings reached between the United States and the Government of Israel regarding implementation of the loan guarantee program.
-- Commit to working with the U.S. Government to resolve outstanding procurement issues.

SUBSEQUENT DISBURSEMENTS

Subsequent disbursements of bond guarantees will be conditioned upon determination and implementation of the GOI,s macroeconomic, structural and other targets developed through the USG-GOI joint consultative mechanism. Fiscal targets and implementation of the reform plan will be the main foci. In particular, disbursements of the third tranche of bond guarantees will be conditioned on achievement of the spending and budget deficit targets for 2004 and 2005. The extent to which other commitments made for the 2004 disbursement are met will also be an important consideration.

End Text of Appendix 4

Begin Text of Appendix 5

DEFINITION OF 2004 EXPENDITURES TARGET

¶1. Definition of 2004 expenditures target
-- For the purpose of releasing the second tranche of bond guarantees, as described in Appendix 4 Annex II (as amended) of the Loan Guarantee Commitment Agreement, the 2004 expenditures target of 226.1 billion New Israeli Shekels shall be defined as:

GOI gross expenditures, as set forth in the annual budget law, less the repayment of principal on debt (except for the repayment of principal on debt related to social security),

plus expenditures on government hospitals. (Footnote 1: In terms of expenditure classification, a corresponding definition of the 2004 expenditures target comprises of Total Expenditures and Credit Granted as defined in the GOI,s Gross Expenditures by Economic Classification plus expenditures on government hospitals.)

-- Based on this definition, the projected 2004 expenditures target is outlined below:

Table 1: Composition of 2004 expenditures target (by expenditure category)

2004 Expenditures Target	226.1
¶1. Total Expenditures and Credit	221.1
Civilian Consumption	42.6
Defense consumption	48.0
Transfers and subsidies	68.6
Investments and credit	14.7
- Direct investment	8.7
- Credit	6.0
Interest payments	35.7
Payback of principal to NII	6.4
Change in Contingency Reserves	5.1
¶2. Government Hospitals	5.0

Source: Ministry of Finance

¶2. Definition of real expenditures growth. In accordance with Appendix 4 Annex II (as amended):
-- The increase in the sum of the government,s expenditures, excluding hospitals, in every year between 2005 and 2010, shall not exceed 1% in real terms relative to the sum of government expenditure in the preceding year.
-- Calculation of real expenditure growth for this purpose shall be based on the following parameters and assumptions:
1.Nominal Expenditure shall be defined in accordance with the definition set out in Appendix 5 section 1.
2.The 1% real expenditure growth limit shall apply to original budget plan to the previous year.
3.Calculation of forecasted real expenditures growth shall be based the annual average CPI forecast as established in the GOI budget.
4.Calculation of actual real expenditures growth shall be based on the annual average CPI published by the Central Bureau of Statistics. For this purpose the GOI will provide actual budget results.

¶3. Forecasted indicative expenditures targets
-- Below are the forecasted expenditures targets for 2005 and 2006, based on the expenditures target definition as above.

Table 2: Forecasted indicative expenditure targets for FY05-06 (current NIS million)

	2004 (original budget)	2005 (forecast)	2006 (forecast)
Expenditures	226.1	234.6	243.1
¶1. Total Expenditures and Credit granted	221.1	229.4	237.7
Thereof: Credit granted	6.0	6.2	6.5
Revenue-dependent	12.3	12.7	13.2
Net expenditure without credit	202.8	210.4	218.0
Interest	42.1	43.7	45.2
Ministries	160.7	166.7	172.8
¶2. Gov. Hospitals	5.0	5.2	5.4
Forecast of CPI Changes		2.7%	2.6%

Source: Ministry of Finance estimates

End Text of Appendix 5

LeBaron